State of California Department of Consumer Affairs

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Initial Statement of Reasons

Regulation Notice for Section 54.1

July 2004

BOARD OF ACCOUNTANCY

INITIAL STATEMENT OF REASONS

Hearing Date: September 10, 2004.

Subject Matter of Proposed Regulation: Disclosure of Confidential Information Prohibited.

Section Affected: Section 54.1 of Title 16

Specific Purpose:
This proposal would add the word "written" to the first paragraph of Section 54.1 which would become subsection (a). This revision would indicate that the licensee shall obtain the client's written permission to disclose confidential information. This proposal would also add a new subsection (b) to indicate that in the event confidential information is disclosed outside the United States, the licensee shall inform the client in writing and obtain the client's written permission to do so.

Factual Basis/Rationale:
The Board was asked by Senator Figueroa, Chair of the Joint Legislative Sunset Review Committee, the Senate Business and Professions Committee, and the Senate Select Committee on International Trade Policy and State Legislation, to consider questions related to the outsourcing of financial information to foreign countries for tax preparation and other purposes. Concerns had been raised regarding the privacy and security of this information.

While current Section 54.1 addresses confidential client information, it does not specify that the client's permission to disclose this information must be in writing, nor does it require that the client be informed that this information may be sent overseas.

Amendments to Section 54.1 are necessary to address these concerns. Amendments revise Section 54.1 to require that the client's permission to disclose confidential information be in writing and to provide that, in the event confidential client information may be disclosed to persons or entities outside of the United States, the licensee inform the client in writing and obtain the client's written permission. These amendments to Section 54.1 will give the client the opportunity to make additional inquiries of the licensee regarding the outsourcing process. The amendments will also help ensure that clients have the information they need to make informed choices regarding the disclosure of their financial information.

Underlying Data:
The Board relied on information presented orally at the February 26, 2004 meeting of its Committee on Professional Conduct. (See Attachment A for excerpts from the minutes of that meeting.)

Business Impact:
This regulation will not have a significant adverse economic impact on businesses. This initial determination is based on the following: anecdotal evidence indicates that compliance with the amended regulation will not represent a significant change from current practice. Many licensees currently obtain written permission from the client even though it is not required by the current language in Section 54.1. Also, additional written information can easily be provided to clients in engagement letters which are used for most CPA services. Further, representatives of the profession who participated in the discussion of this proposal did not indicate that this proposal will have a negative economic impact on licensees.

Specific Technologies or Equipment:
This regulation does not mandate the use of specific technologies or equipment.

Consideration of Alternatives:
No reasonable alternative to the regulation would be either more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed regulation.

Set forth below is the alternative which was considered and the reasons it was rejected:

(a) No confidential information obtained by a licensee, in his or her professional capacity, concerning a client or a prospective client shall be disclosed by the licensee without fully informing the client about the nature of the disclosure and obtaining the written permission of the client or prospective client.
~~(a)~~(1) disclosures made by a licensee in compliance with a subpoena or a summons enforceable by order of a court;
~~(b)~~(2) disclosures made by a licensee regarding a client or prospective client to the extent that the licensee reasonably believes that it is necessary to maintain or defend himself/herself in a legal proceeding initiated by that client or prospective client;
~~(c)~~(3) disclosures made by a licensee in response to an official inquiry from a federal or state government regulatory agency;
~~(d)~~(4) disclosures made by a licensee or a licensee's duly authorized representative to another licensee in connection with a proposed sale or merger of the licensee's professional practice;
~~(e)~~(5) disclosures made by a licensee to (1) another licensee to the extent necessary for purposes of professional consultation and to (2) professional standards review, ethics or quality control peer review organizations;
~~(f)~~(6) disclosures made when specifically required by law.

(b) "Fully informing the client about the nature of the disclosure" means that licensee shall provide the client with a written statement listing the identity of all individuals or entities to whom the information will be disclosed, including any subsequent disclosure that might be made by those individuals or entities to others, the confidential information that will be disclosed, the reason for the

disclosure, and the location of all individuals or entities who will receive the confidential information.

This alternative was rejected because it appeared to be burdensome to licensees and could negatively impact their ability to provide services to their clients. It was noted that the licensee may not know, when undertaking the engagement, the identity of all those who will be performing the work. Requiring that this information be disclosed when it becomes available might require the licensee to go through client records several times in order to add the additional disclosures. This could be burdensome for licensees. It was also noted that Section 54.1 applies to all CPA services, not just tax returns, and requiring disclosure of the identity and location of the individuals or entities involved could be a serious impediment in multi-national transactions.

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Attachment A

COMMITTEE ON PROFESSIONAL CONDUCT
MINUTES OF THE MEETING

FINAL

February 26, 2004
The Westin St. Francis
335 Powell Street
San Francisco, CA 94102

CALL TO ORDER

Ronald Blanc, Chair, called the meeting of the Committee on Professional Conduct (CPC) to order at 8:30 a.m. Mr. Blanc indicated that to ensure compliance with the Bagley-Keene Open Meeting Act, when a quorum of the Board is present at this meeting (eight members of the Board), Board members who are not serving on the CPC must attend as observers only.

Present
Ronald Blanc, Chair
Richard Charney
Charles Drott
Gail Hillebrand
Wendy S. Perez
Renata Sos

Staff and Legal Counsel
Mary Crocker, Assistant Executive Officer
Patti Franz, Licensing Manager
Michael Granen, Deputy Attorney General
Aronna Granick, Legislation/Regulations Coordinator
Bob Miller, Legal Counsel
Greg Newington, Chief, Enforcement Program
Susan Ruff, Deputy Attorney General
Carol Sigmann, Executive Officer
Jeannie Werner, Deputy Attorney General

Other Participants
Bruce Allen, California Society of Certified Public Accountants
Tom Chenowith
Nancy Corrigan, Qualifications Committee Chair
Mike Duffey, Ernst and Young LLP

Dennis Eagan, Deputy Attorney General
Olaf Falkenhagen, SOX Cascade Effects Task Force Member
Julie D'Angelo Fellmeth, Center for Public Interest Law
Art Kroeger, Society of California Accountants
Richard Robinson, Robinson & Associates
Hal Schultz, California Society of Certified Public Accountants
David Swartz, SOX Cascade Effects Task Force Member

Board Members Observing:
Ruben Davila
Tom Iino
Ian Thomas

I. Outsourcing of Accounting Services.
   A. Report by the California Society of Certified Public Accountants, the Society of California Accountants, and the Accountants Coalition.
   B. Report on State and Federal Laws Related to Outsourcing and Privacy Protection.

Mr. Blanc began the discussion of this agenda item by noting that the issue of the outsourcing of accounting services was referred to the CPC at the November 2003 Board meeting. At that meeting, it was noted that tax preparation work was being outsourced to foreign countries and it was unclear what security and privacy protection mechanisms were in place. The Board was asked to obtain information from the profession regarding outsourcing, including researching who is doing it, how it is conducted, how it is disclosed, and whether clients are adequately informed that tax and financial information is being sent electronically to subcontractors outside the U.S. The Board was also asked to research who assumes responsibility when the firm or practitioner chooses to outsource the work. Further, realizing the potential for identity theft and other financial fraud, the Board was asked to consider what security requirements are in place.

Mr. Blanc also indicated that Board President, Ian Thomas, reported on the matter at the Board's Sunset Review Hearing in January 2004 and the Board was encouraged to continue its work. He added that recently, he and Mr. Thomas were invited by Senator Figueroa to participate in a joint hearing on outsourcing before the Select Committee on International Trade Policy and State Legislation and the Senate Business and Professions Committee scheduled for March 9, 2004 (Attachment 1). He noted that the Senator is concerned regarding the privacy, security, and disclosure requirements of companies outsourcing accounting work and with the potential for identify theft and other financial fraud once documents are sent to third-party providers overseas. Mr. Blanc concluded his introductory remarks by indicating that the CPC is interested in obtaining information from the profession on outsourcing and the disclosures made to clients.

Mr. Robinson offered comments on behalf of his clients the "Big Four" accounting firms. He explained that the majority of tax returns are prepared by tax preparers such as H&R Block rather than by CPAs. He indicated that when this issue arose, the law firm of Gibson, Dunn, and Crutcher was engaged to gather information regarding his clients' practices. This project is not completed, and no written information is available.

Mr. Robinson reported that because of existing professional standards and requirements, including the AICPA's professional standards, the Internal Revenue Service Code, and the Board's regulations, clients of CPAs are better protected than client and customers of other businesses and professions. He reported that his clients have expertise in IT protection and security and that he was not aware of any security problems related to sending information outside the U.S. He also noted that confidentiality is fundamental to the practice of public accounting and that existing professional standards require licensees to take full responsibility for their work products even when some of the work is outsourced. Mr. Robinson further noted that outsourcing is a global issue that involves many other entities besides licensees of the Board.

Mr. Allen then presented comments on behalf of the California Society of Certified Public Accountants (CalCPA). Mr. Allen reported that he talked with many CPAs, and most do not outsource. Those who do outsource to so to avoid hiring additional temporary help for tax season and so they can provide clients with prompt service. CalCPA's insurance carrier, CAMICO, advises CPAs that if services are outsourced outside the United States, that this be disclosed in the engagement letter. He also noted that CAMICO has not had any claims related to outsourcing. Mr. Allen added that CalCPA believes the profession is adequately regulated by the Board and by self-regulation. Mr. Allen agreed with Mr. Robinson that outsourcing is a large, global issue and that the CPA profession should not be the focus of concern.

Mr. Kroger presented comments on behalf of the Society of California Accountants (SCA). He reported that he had informally surveyed some SCA members, and only a small percentage were in favor of outsourcing. They were concerned about confidentiality, disclosure, and due diligence.

Mr. Blanc then asked for comments from Deputy Attorney General Susan Ruff. Ms. Ruff indicated that she had reviewed both state and federal laws and that the details of her analysis are provided in her memorandum (Attachment 2). She noted that the greatest consumer protection is provided by the Board's Regulation, Section 54.1, which restricts disclosure without client consent. She added that Section 54.1 is very general and it might be wise for the Board to tighten up the language to better ensure that the public is protected. Her recommendation was that 54.1 be broken into two parts. Part (a) would be the current regulation with the addition of the following language:

> **54.1** (a) No confidential information obtained by a licensee, in his or her professional capacity, concerning a client or a prospective client shall be

disclosed by the licensee without fully informing the client about the nature of the disclosure and obtaining the written permission of the client or prospective client….

Subsection (b) would then read as follows:

(b) "Fully informing the client about the nature of the disclosure" means that licensee shall provide the client with a written statement listing the identity of all individuals or entities to whom the information will be disclosed, including any subsequent disclosure that might be made by those individuals or entities to others, the confidential information that will be disclosed, the reason for the disclosure, and the location of all individuals or entities who will receive the confidential information.

After discussion, it was moved by Ms. Hillebrand, seconded by Ms. Sos and unanimously carried to require that the permission of the client be in writing.

It was then moved by Ms. Perez and seconded by Ms. Hillebrand that, when requesting the client's permission, the licensee inform the client that information may be disclosed to persons or entities outside the United States in connection with the services to be provided.

Ms. Sos asked for Ms. Ruff's view of Ms. Perez' motion. Ms. Ruff expressed concern that the motion may be creating boilerplate language that would not fully inform the client. Ms. Sos expressed concern that adding this language to the first paragraph of Section 54.1 would narrow the currently broad language in Section 54.1. **Ms. Sos suggested a separate subsection that would indicate that in the event client information may be disclosed to persons or entities outside the United States, the licensee would obtain the client's written permission. Ms. Perez and Ms. Hillebrand, the maker and seconder of the motion, agreed that the motion should include the modification suggested by Ms. Sos.** During the discussion, Mr. Robinson indicated he believed it was important that the word "may" be used in the revised regulation. **After discussion, the motion was unanimously carried.**

Ms. Hillebrand then suggested that the CPC could also consider requiring disclosure of who will be providing the service, where they are located, and the nature of the service provided. Ms. Ruff commented that at some point the licensee may make a decision that the client's personal financial information will be outsourced for a particular purpose, and at that time it would be appropriate for the licensee to disclose this to the client. Mr. Granen indicated it may also be important for the client to be informed regarding how long the information will be held. Ms. Hillebrand suggested that it was a policy question whether this additional information should be part of the disclosure to the client or should instead be retained in the licensee's records.

During the discussion, Ms. Perez questioned whether there would be any consumer protection benefit in informing clients about the identity of the individuals performing the

work. Mr. Blanc noted that it could be burdensome for the licensee to go through client records and add additional disclosures. He indicated that an initial disclosure would be adequate. Mr. Drott suggested that perhaps the disclosure should inform the client that, while every effort is made to provide for the confidentiality of client financial information, there is no guarantee.

Ms. Perez expressed support for making no further changes to Section 54.1. She noted that the existing regulation provides good consumer protection and that the minor revisions approved by the CPC are appropriate and adequate to provide clear disclosure and enable consumers to make informed choices. Mr. Robinson also expressed support for making no further revisions to Section 54.1. Mr. Blanc suggested that the CPC wait until after the March 9, 2004, hearing to consider any further revisions to Section 54.1.

After discussion it was moved by Ms. Hillebrand, seconded by Ms. Sos, and carried to recommend to the Board the two revisions to Section 54.1 approved by the CPC and to indicate that the CPC is continuing to consider whether to also require disclosure of the name of the contractor, where the contractor is located, the nature of the services, and how long client information could be retained by the contractor (five "ayes" and one "no").

Mr. Drott expressed concern that consumers may overestimate the degree of control the licensee has over the outsourced information. He indicated it was important for the CPC to consider this matter and that it could also be discussed at the hearing. **After discussion, it was moved by Ms. Perez and seconded by Ms. Hillebrand to not make a proposal at the hearing regarding the issue of reducing the licensee's liability by requiring a disclaimer in the engagement letter.** Mr. Drott indicated that the consumers may not be well informed, and the "expectation gap" needed to be addressed in some way. Ms. Crocker suggested that the expectation gap be addressed through consumer education, for example on the Board's Web site. Mr. Miller noted that if the CPC voted in favor of Ms. Perez' motion, it would not necessarily restrict the CPC from addressing the same issue at a future meeting. **After discussion the motion carried (five "ayes" and one abstention).**

II. Revision of the Board's Definition of Supervision in Regulation Sections 12 and 12.5 (Pending Pursuant to Executive Order S-2-03)

Ms. Corrigan reported that at the November 13, 2003, Board meeting, the past Chair of the Qualifications Committee (QC) reported on the planned implementation of the revisions to Sections 12 and 12.5 related to supervision. It was suggested that one unintended consequence of the new language would be that there may be significant delays in the licensure process. The Board asked the QC to take this under consideration and report back.

Ms. Corrigan indicated that the QC has reviewed the matter and concluded that if an applicant is on a standard track, it may take two to three years for licensure, while under

the new definition it may take as long as four to five years. The reason for this difference is that many applicants are not directly supervised by licensees. She noted that in one big firm she is familiar with less than 10 percent of the seniors who supervise audit field work are licensed. However, by the time the manager level is reached, all have to be licensed. She added that an additional delay would be created because, under the new definition of supervision, numerous forms would be submitted and would need to be reviewed individually, while currently one form summarizing the applicant's experience can be submitted.

Ms. Corrigan added that the QC concluded that in public accounting and in government there is a hierarchy of oversight and a system of quality control which ensures that applicants receive the appropriate experience even when the applicant's immediate supervisor is not licensed. To address this mater, the QC recommended that the supervisor be defined as the one who has overall engagement control and the ability to make directional changes in the engagement. These licensees have the ability to get the information from those directly supervising the applicant in the field.

Ms. Crocker indicated that the CPC had received language that morning and that there was also draft regulatory language in the packet (Attachments 3 and 4). Both versions represent staff's efforts to revise Sections 12 and 12.5 consistent with the QC's recommendation. Mr. Blanc expressed concern that representatives of the profession and members of the public may not have had adequate time to review the language.

Ms. Franz provided background information regarding the reason the Board adopted the definition of supervision which was added to Sections 12 and 12.5. She reported that the definition was intended to resolve confusion regarding who the applicant's supervisor was and who was authorized to verify the applicant's experience. She noted that staff had received numerous inquiries on this subject. The definition of supervision, which was adopted by the Board in July 2003, clarified the Board's expectations. Ms. Perez added that, during the Board's consideration of the matter, Board members had reviewed a particularly egregious example in which a licensee on the east coast claimed to be supervising a California applicant's experience.

Ms. Hillebrand asked for staff's perspective on the QC's proposed policy revision. Ms. Franz indicated that the proposal was workable and would be easier to administer because fewer forms would be submitted. She noted that the information Ms. Corrigan provided indicated that the direct supervisor may not be a licensee. However a licensee would consult with the direct supervisor regarding the applicant's experience before signing the form. Ms. Franz added that this would be a change from the Board's previous position, but she anticipated staff would be able to clearly communicate this new position to applicants and licensees.

After discussion, participants concluded that the issue was complex and there was not adequate time to address it fully at this meeting. It was also noted that while the QC had developed a policy recommendation, QC members had not had an opportunity to

consider implementing regulatory language. **Based on these concerns, it was the consensus of the CPC to defer action on this matter until its next meeting.**

III. Fraud Continuing Education Requirement in Regulation Section 87 (Pending Pursuant to Executive Order S-2-03).

Consideration of this agenda item was deferred.

IV. Attorney General's Legislative Proposal Related to Charitable Trusts.

Mr. Blanc noted that this matter was referred to the CPC from the SOX Cascade Effects Task Force. When the Task Force met on February 2, 2004, participants referenced the Attorney General's proposal related to charitable trusts, but it was not available for review. It has now been introduced as SB 1262 by Senator Sher (Attachment 5) and is before the CPC for consideration.

Deputy Attorney General Dennis Eagin, provided the CPC with an overview of the provisions of SB 1262 most relevant to the Board. He called the CPC's attention to subdivision (e) of Section 12586 on page 10 of the bill. He noted that it would require charities reporting to the Attorney General, that have gross revenues of $500,000 or more, to have an annual independent audit conducted in accordance with generally accepted auditing standards. The audit firm would not be permitted to provide any additional services to a charity that it audits, except for the preparation of tax returns. The audited financial statements would be available to the Attorney General and to the public. Further, if the charity is a corporation, it would be required to have an audit committee which would be responsible for retaining the auditor, setting the auditor's compensation, and approving the audit. Audit committee members would not be able to serve on the corporation's finance committee. Mr. Eagin indicated that his office had considered audit firm and audit partner rotation requirements, but that these requirements were not included in the bill.

Mr. Falkenhagen commented that he believed the bill was too restrictive with regard to nonaudit services. He noted that because the auditor is knowledgeable about the organization, additional services could be provided by the auditor at a very reasonable cost. He added that the Sarbanes-Oxley Act (SOX) permits nonaudit services as long as they are preapproved by the audit committee. Further, the U.S. General Accounting Office, which has responsibility for audits of entities that receive federal funds, recently revised its audit guide (the Yellow Book). The Yellow Book continues to allow auditors to provide nonaudit services as long as they do not impair independence. Mr. Robinson agreed with Mr. Falkenhagen that SB 1262 was more restrictive than SOX and expressed support for amending the bill to permit the audit committee to preapprove nonaudit services.

Mr. Falkenhagen also expressed concern regarding the provision in SB 1262 that would prevent the same directors from serving on both the audit and the finance committees of

the charity. He indicated that many charities with which he is familiar combine the two committees, and he could see no benefits in separating the membership. He also expressed concern regarding a provision that would prevent audit committee members from having a material financial interest in an entity doing business with the charity. He noted that this could prevent knowledgeable, well qualified people from serving on the audit committee.

Mr. Falkenhagen added that he was also concerned with the language that required the audit committee to "approve" the audit. Ms. Sos agreed that this was an area of concern. Mr. Drott suggested that the word "approve" be defined.

Ms. D'Angelo Fellmeth expressed concern regarding the requirement on page 10 of SB 1262 that the audit be conducted in conformity with generally accepted auditing standards. She noted that California law has more stringent standards in the area of audit documentation. She suggested that the language could be broadened to take this into account.

After the discussion, Mr. Blanc thanked Mr. Eagin for attending and providing information on SB 1262. Mr. Eagin reported that the bill is a work in progress and that the comments provided at the meeting were appreciated. Mr. Blanc indicated that he believed the critical elements of SOX are covered by the bill and there was no need for the CPC to recommend any changes. Ms. Sigmann noted that the Board would have another opportunity to review the bill at its May meeting.

V. Comments from Members of the Public.

Members of the public provided their comments during the course of the meeting.

VI. Agenda Items for Next Meeting.

Mr. Blanc indicated that at the next meeting the CPC would continue its discussion of outsourcing including a review of proposed amendments to Section 54.1 and a discussion of possible additional disclosures and due diligence requirements for licensees. In addition there would be a report on the March 9, 2004, legislative hearing. Consideration of amendments to Section 12, 12.5, and 87 of the Board's Regulations was also scheduled for the next meeting.

There being no further business, the meeting was adjourned at 12:15 p.m.

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California State Senate

SENATOR
LIZ FIGUEROA
TENTH SENATORIAL DISTRICT

SENATE COMMITTEE ON
BUSINESS AND PROFESSIONS
CHAIR

Attachment 1

COMMITTEES:
ENVIRONMENTAL QUALITY
HEALTH AND HUMAN SERVICES
INDUSTRIAL RELATIONS
INSURANCE
TRANSPORTATION

MEMORANDUM

To: Ian Thomas, President, California Board of Accountancy

From: Senator Liz Figueroa, Chair
Select Committee on International Trade Policy and State Legislation
and the Senate Business and Professions Committee

Date: February 9, 2004

Subject: Invitation to Appear at the March 9th Joint Information Hearing on the Subject of Outsourcing of Accounting Services to other Countries.

I would like to have you and your Chair of the Committee on Professional Conduct (CPC), Mr. Ronald Blanc, testify at the joint hearing of the Select Committee on International Trade Policy and State Legislation and the Senate Business and Professions Committee, regarding the outsourcing of accounting services to other countries. We will be conducting the joint information hearing on March 9, 2004, at 9:00 a.m., in Room 2040, at the State Capitol in Sacramento.

The joint hearing will be investigating several different aspects of outsourcing work and services to other countries, including state contract jobs, preparation of medical information and accounting and finance functions – such as tax preparation and property appraisals.

As part of our investigation of the practices surrounding the outsourcing of accountancy and tax preparation services, I am most concerned with the security and confidentiality of financial information that may be sent to another country, and other controls and disclosure practices that are in place to both inform the public and protect their financial information.

It is our understanding that accounting firms, independent certified public accountants (CPAs), taxpreparers, enrolled agents, tax preparation companies and other financial businesses may be utilizing the services of third-party providers (companies) that are outsourcing tax preparation work, as well as other accounting and financing services, to at least one country, India, where the

actual work is performed and then returned to the California business or practitioner once completed. This includes sending all financial data, including bank and brokerage account numbers, and social security numbers of their clients. It is unknown what privacy, security and disclosure requirements are currently required by these companies outsourcing the accounting work, or for the outsourcing business or individual practitioner. According to a recent article in a San Francisco paper, few clients are probably aware – or are being informed – that their sensitive financial information may be spanning the globe. What is alarming is that the national association for CPAs, the American Institute of Certified Public Accountants (AICPA), seems to endorse this new practice of outsourcing accounting services without discussing any of the problems that may be associated with this practice. In a recent article by AICPA, they indicated that "outsourcing, some observers believe, is the wave of the future for its ability to reduce the time staffers spend on returns and also dramatically reduce the need to hire temporary staff during tax season." AICPA discusses the advantages of outsourcing, cost savings, etc., and the names of the companies providing outsourcing on behalf of accounting firms and CPAs and how they operate.

With concerns expressed about the potential for identity theft and other financial fraud that could be committed once documents are sent to third-party providers and then overseas, and whether or not there are real controls on the distribution of this personal financial information, and whether the client is even aware of this practice, it would seem appropriate that the Legislature investigate the outsourcing practice being utilized by tax and accounting professionals and whether there are certain privacy protections, disclosure requirements and other controls that need to be implemented by the Legislature.

We expect to have others testifying who represent the accountancy and taxpreparer profession, as well as others involved in the outsourcing of financial information to other countries. We also expect a representative from one of the third party provider companies to testify at the hearing as well. I understand that the CPC of the Board will be reviewing this issue at its next meeting prior to our hearing on March 9th. I would like the Board to bring our committees up-to-date on the discussions and information presented at the CPC meeting and what plans the Board may have to deal with the disclosure, security and confidentiality issues that surround the practice of providing third-party providers with accounting work that is prepared in another country. I am also concerned about how the Board can assure the competence, practices and procedures of the firm or the CPA when using a third-party provider, so that professional services are performed with professional competence and due professional care.

Please let us know if you can both attend. Contact Bill Gage in the Senate Business and Professions Committee at #(916) 445-3435 to confirm your attendance.

Attachment 2

BILL LOCKYER
Attorney General

State of California
DEPARTMENT OF JUSTICE

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February 19, 2004

Carol Sigmann
California Board of Accountancy
2000 Evergreen Street, Suite 250
Sacramento, CA 95815-3832

RE DISCUSSION OF LAWS RELATED TO "OUTSOURCING"

Dear Ms. Sigmann:

The Board has requested that I provide an analysis of the current laws and regulations that might be applicable to the practice of "outsourcing" tax preparation work.[1]

Accounting firms, in increasing numbers, are outsourcing tax preparation work to individuals in foreign countries.[2] In a typical outsourcing situation, the California accountant or accounting firm contracts with an outside company who contracts with foreign accountants to do tax preparation work. These foreign accountants have access to the personal and financial information of the client of the California accountant and prepare the client's tax return, which is sent back to the California accountant. The client may never know that someone other than the accountant reviewed his or her personal and financial information.

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[1] This memorandum is intended to assist the Board in its discussion of the outsourcing issue and the Board's consideration of any legislation or regulations that might be appropriate to protect California consumers. It is not intended to be a definitive legal opinion regarding accountants' duties regarding client notification, nor should it be relied upon by members of the accounting industry to determine their duties or liabilities under the law.

[2] This analysis focuses on accountants, but the same consumer protection concerns apply to all tax preparers who outsource their work to third parties, not just accountants. In fact, the consumer protection concerns may be even greater when dealing with tax preparers who are not certified public accountants, because those non-accountant tax preparers may not have the fiduciary and professional obligations to their clients that CPAs have.

Obviously, there are privacy and security concerns when clients' personal and financial information is reviewed by people in foreign countries which may not have the same types of criminal and consumer protection laws as the United States. Given the fact that an income tax return contains personal information such as date of birth, social security number and bank account information, the possibility of identity theft from such disclosures is a very real concern. Although no laws directly address the outsourcing of tax preparation work, there are several federal and state laws and regulations that address the privacy issues related to outsourcing.

Federal Law – The Gramm-Leach-Bliley Act

The Gramm-Leach-Bliley Act (the "GLB Act") contains a series of privacy provisions that require financial institutions to notify consumers when certain personal information is disclosed by the financial institution to third parties. (Title 15, U.S.C. §§ 6801 - 6827.) The GLB Act also provides that consumers may choose to "opt out" in certain situations and refuse to allow the financial institution to transfer personal, financial information to third parties. The GLB Act only applies to information collected about individuals "who obtain financial products or services primarily for personal, family or household purposes...." It is not intended to protect businesses or commercial activities. (16 CFR § 313.1(b).)

The GLB Act distinguishes between two different categories of people who must receive privacy notices: "consumers" and "customers." Customers are considered to have a more extensive relationship with the financial institution and must receive more detailed notices than consumers.

The GLB Act authorizes various federal agencies to promulgate regulations to carry out the act and permits those agencies to create additional exceptions to the requirements of the act. (Title 15 U.S.C. § 6804(b).) For purposes of accountants and tax preparers, the applicable federal agency is the Federal Trade Commission ("FTC"). (Title 15 U.S.C. § 6805(a)(7).)

The FTC regulations make it clear that tax preparers are included among the financial institutions governed by the GLB Act. (16 CFR, Part 313, §§ 313.1(b) and 313.3(k)(2)(viii).) In addition, the FTC regulations provide that an individual who becomes a client "for the purpose of obtaining tax preparation or credit counseling services" has established a "customer relationship" with the tax preparer under the act. (16 CFR § 313.3(h)(i)(2)(H) and 313.4(c)(3)(i)(D).) Therefore, accountants who prepare income tax returns for clients must follow the notice and opt out provisions relating to "customers" set forth in the act.

There are two general sets of requirements in the GLB Act relating to customers. First, there are the requirements for the privacy notices that must be provided to customers. Second, there are the opt out provisions which allow the customer, in certain situations, to prevent disclosure of personal information to nonaffiliated third parties. There are also numerous exceptions to both the privacy notice and the opt out requirements.

Under the privacy notice provisions of the GLB Act, a financial institution (including a tax preparer) is required to send out an initial notice to a customer that accurately reflects the institution's privacy policies and practices. (16 CFR § 313.4(a)(1).) The financial institution must also provide an annual notice when there is an ongoing customer relationship. (16 CFR 313.5(a)(1).) However, in the case of a client who has an income tax return prepared once a year, pays for that service shortly after the work is done, and has no further contact with the accountant until the next tax season, there is probably not a continuing customer relationship (16 CFR § 313.5(b)(2)(v)), and the accountant does not need to provide annual notices to that type of tax client. However, the accountant may be required to provide a new notice the following year, if the client once again seeks out the accountant for tax preparation services. There are also disclosure requirements related to former customers that the accountant might be required to follow.

The privacy notices sent to customers must contain certain disclosures about the information gathering and dissemination practices of the accountant. For purposes of outsourcing, the relevant disclosures appear in 16 CFR § 313.6:

> (a) *General rule.* The initial, annual, and revised privacy notices that you provide...must include each of the following items...
>
> . . .
>
> (3) The categories of affiliates and nonaffiliated third parties to whom you disclose nonpublic personal information....

Although this would seem to require disclosure in the case of outsourcing, there are exceptions to this general disclosure rule. One of the main exceptions to the rule applies when personal information is disclosed "as necessary to effect, administer, or enforce a transaction that a consumer requests or authorizes...." (16 CFR § 313.14(a).) The words "necessary to effect, administer, or enforce a transaction" are defined broadly to include disclosures that are the "usual, appropriate or acceptable method...to carry out the transaction or the product or service business of which the transaction is a part...." (16 CFR § 313.14(b)(2)(i).) When an accountant contracts with a company that provides tax preparation services, that could arguably be an "appropriate or acceptable" method to carry out the service that the customer requested.

Unfortunately, the issue is somewhat more complex, because the FTC regulations are ambiguous as to which exceptions apply when dealing with *customers* as opposed to *consumers*. Section 313.14, discussed in the previous paragraph, refers back to another section, 16 CFR § 313.4(a)(2), which deals with consumers, not customers.

However, based on other FTC regulations, it appears that the FTC intended that the exception would be applicable to customers as well as consumers. For example, 16 CFR § 313.6(c)(5) states:

> *Simplified notices.* If you do not disclose, and do not wish to reserve the right to disclose, nonpublic personal information about customers or former customers to affiliates or nonaffiliated third parties except as authorized under §§ 313.14 and 313.15, you may simply state that fact, in addition to the information you must provide under paragraphs (a)(1), (a)(8), (a)(9), and (b) of this section.

If the FTC only intended the exception created in § 313.14 to apply to consumers, not customers, it would not have listed that exception in a paragraph which deals only with customers and former customers. Therefore, it appears that the FTC intended to create an exception to the general disclosure rule.

Assuming that exception does apply, then the accountant who outsources tax preparation work is not required to disclose the outsourcing companies or individuals to his or her clients. Instead, the suggested FTC disclosure language is as follows:

> We do not disclose any nonpublic personal information about our customers or former customers to anyone, except as permitted by law.

(16 CFR, Part 313, Appendix A-3.)

Even if the exception does not apply, the GLB Act still does not require the accountant to disclose the true nature of the outsourced work. It is doubtful that a general statement about the "categories of nonaffiliated third parties" to whom the personal information is disclosed would be sufficient to alert a client that his or her personal financial information was being reviewed by individuals in other countries.

The same exception also applies to the "opt out" provisions of the GLB Act. If the disclosures are made to effect, administer or enforce a transaction that the consumer requests, then the opt out provisions of sections 313.7 and 313.10 do not apply. (16 CFR § 313.14(a).) It is not necessary for an accountant to give the customer a chance to opt out before disclosing the information in connection with the outsourcing.

Based on this analysis, it does not appear that the GLB Act provides sufficient protection to California consumers when outsourcing is involved. Fortunately, the Act specifically permits states to adopt their own laws with greater privacy protections than those set forth in the GLB Act. (Title 15 U.S.C. 6824; 16 CFR § 313.17.) Therefore, there should be no problem with federal preemption if California passes laws requiring more explicit notice and opportunity for opt out for clients of accountants and other tax preparers.

California Law -- The Dunn Act

California also has a financial privacy provision. Senate Bill 1724 of the 1999-2000 Session, also known as the Dunn Act, prohibits disclosures of certain tax related information. However, an examination of the Dunn Act shows that it does not prohibit outsourcing or require disclosure when accountants and other tax preparers outsource work.

Business and Professions Code section 17530.5 makes it a misdemeanor to disclose information obtained in the preparation of tax returns. However, there is an exception for disclosure that is "necessary to the preparation of the return." (Bus. & Prof. Code § 17530.5(a)(3).) If the outsourcing is done for the purpose of preparing tax returns, it would appear to come within that exception to the law.

A new section added by the Dunn Act, Civil Code section 1799.1a, provides that no person shall disclose information obtained from a tax return. Once again, that section provides an exception when the disclosure is "necessary to complete or service the financial or business-related transaction." (Civil Code § 199.1a (a)(3).) It also provides that the "treatment of tax returns by tax preparers" is governed by Business and Professions Code section 17530.5.

The Accountancy Act and Board Regulations

The Board's own regulations contain two provisions that may affect outsourcing of tax return preparation. Business and Professions Code section 5018 authorizes the Board to promulgate regulations regarding professional conduct. Pursuant to this authority, the Board promulgated two regulations, Title 16, California Code of Regulations, sections 54 and 54.1. These two regulations prohibit the disclosure of confidential information obtained by a licensee from a client without the permission of the client. There are exceptions to the prohibition, but they do not appear to be applicable to outsourcing of accounting work to third parties.

For example, there is an exception for "disclosures made by a licensee to...another licensee to the extent necessary for purposes of professional consultation... ." (Title 16, California Code of Regulations, section 54.1(e).) However, this exception does not appear to apply when outsourcing includes accountants who are not California licensees.

Therefore, at least on the face of these two regulations, California accountants must obtain their clients' permission before they can disclose confidential information to third parties, even if that disclosure is made for purposes of outsourcing tax preparation work. However, the regulations are vague as to what type of disclosure must be made and whether the permission must be obtained in writing. For example, an accountant might simply tell the client that a third party assists with the preparation of the return without giving the client full disclosure about the true nature of the outsourcing.

Further, the Board's regulations apply only to Board licensees. They are not sufficient to protect consumers from outsourcing done by tax preparers who are not California licensed accountants.

Other Federal and State Laws

Title 26 U.S.C. §7216 prohibits a tax preparer from knowingly or recklessly disclosing information furnished to him in connection with the preparation of a tax return. However, there are various exceptions to this general rule, including an exception for information provided by a tax preparer to another tax preparer "for the purpose of having the second tax return preparer transfer that information to, and compute the tax liability on, a tax return of such taxpayer by means of electronic, mechanical, or other form of tax return processing service." (26 CFR § 301.7216-2(h).) Title 26 U.S.C. §6103 also forbids disclosure, with certain exceptions, but that section involves government employees, not private tax preparers.

California Civil Code § 1798.83, as of January 1, 2005, will require businesses to make certain disclosures to their customers when personal information is provided to third parties and used by those third parties for marketing purposes. However, that section does not appear to apply to the current situation since outsourcing is done to assist with processing the tax preparation, not to provide information to marketing companies.

Conclusion

Despite the various laws and regulations relating to financial privacy, there is still a concern that tax preparation clients in California are not receiving proper notice that their private financial information is being sent to other countries for tax preparation. This is an issue that appears to warrant further legislation or stronger regulatory provisions in order to protect the public.

Thank you for the opportunity to assist the Board with these issues. If I can provide any further information to the Board related to these issues, please let me know.

Sincerely,

SUSAN A. RUFF
Deputy Attorney General

For BILL LOCKYER
Attorney General

cc: Alfredo Terrazas